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INCREASING FINANCIAL INCLUSION THROUGH ISLAMIC BANKING IN INDIA

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ABSTRACT

Financial inclusion has been recently gaining popularity and interest by economists as it has been widely accepted that financial inclusion is critical for poverty reduction. Financial inclusion results in increased savings and entrepreneurial innovations, improved education and empowerment of women. Financial inclusion is critical to reduce income inequality and thus results in accelerated economic growth. Studies have revealed that sometimes financial services are available but still people do not use it. The reasons vary from high costs of usage of services to difficult paperwork to other legal hurdles or barrier like religion which prohibits usage of certain types of financial services. Fortunately, there is a growing recognition globally that the governments and/ or central regulators should make policies to reduce different types of barriers and increase financial inclusion in their countries. India is home to 21% of the world's unbanked population. In India, more than 50% of the financially excluded are the Muslims. The foremost priority of Islam and its teachings on economics is justice and equity. This paper focuses on the possibility of increasing financial inclusion through Islamic Banking.

KEYWORDS: Economic Growth, Financial Exclusion, Financial Inclusion, India, Islamic Banking

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Original Article

INTRODUCTION

It is an established fact that the key driver of economic growth and development is financial development and intermediation. The financial system evolves when a structure is developed by financial intermediation between savers and borrowers along with a combination of information, transaction costs and different legal, regulatory and tax systems. Financial systems should be such that on one hand it is able to motivate savers to save and design financial instruments that may meet the needs of the savers and on the other hand these savings should be made available to the investors at an attractive rate for their business needs. Although apparently it may look contradictory, but is true, that high degree of financial development may not necessarily be an indicator of alleviation of poverty. Having realised this bitter truth with the experience of the last century, now there is an increasing advocacy that the financial development should include more financial inclusion that will play a positive role in poverty eradication. It is believed that increasing the access of basic financial services to the deprived section of the society, like deposition of savings, availability of credit and insurance, may lead to sustainable growth and productivity.

The paper suggests that since the core principles of Islam is social justice, inclusion and sharing of resources between the haves and the have not's, Islamic finance may be able to solve the problem of financial exclusion.

There could be two-way solution to the problem of financial exclusion through Islamic Banking – one through promoting risk-sharing contracts which are way better than interest based credit and the other through redistribution of wealth.

GLOBAL SCENARIO OF FINANCIAL INCLUSION

Financial inclusion is one of the most discussed themes at national and international level nowadays. Financial inclusion is defined as the share of the population who uses financial services, according to the World Bank 2014 Global Financial Development Report. Many empirical studies have shown positive relation between access to savings accounts and increased savings, investment, consumption or income. Also, it is observed that increased access to the availability of credit results in increased entrepreneurship and reduction in poverty. The extent of financial inclusion is dependent on the size of a country and the number of banking firms present in the country. It is easier and cheaper to expand financial services in smaller countries with population in urban areas unlike a vast country like India with majority of the population living in rural areas. Presence of large number of banks or financial institutions is found to result in increased financial inclusion. There has been a remarkable increase in the world's adult population who has an account. According to the World Bank's Global Findex Database 2014, the world's population having an account has increased remarkably from 62% while it was only 51% in 2011.

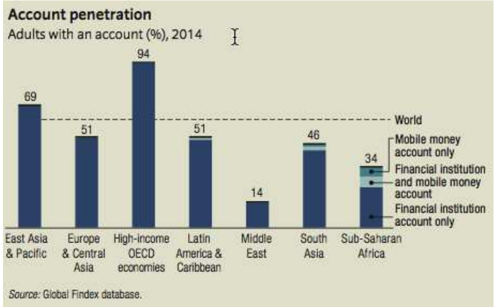

Figure 1

According to the report, globally, 2 billion adults remain unbanked. South Asia, East Asia and the Pacific together account for more than half of the world's unbanked adults. The three most populous developing countries — China, India, and Indonesia account for about 39 percent of the world's unbanked. India is home to 21 percent of the world's unbanked adults and about two-thirds of South Asia's. China accounts for 12 percent of the world's unbanked and Indonesia for 6 percent.

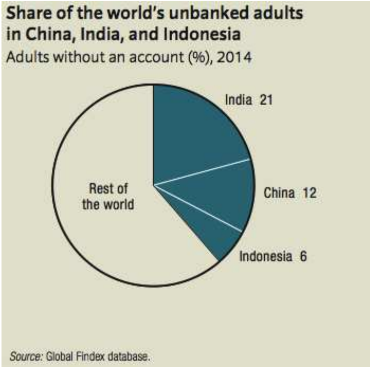

Figure 2

FINANCIAL EXCLUSION AND THEIR REASONS

Financial exclusion can be categorised into two – voluntary and involuntary. Voluntary exclusion means that people deliberately do not participate or use the available financial services and involuntary exclusion includes those group of people who wish to have accounts and banking facility but the lack of it keeps them deprived. The estimated number of voluntary exclusion is very small percentage globally but in absolute figures constitutes a large number of people and efforts should be made to make them participate. Reasons for financial exclusion involuntarily include insufficient funds, difficult paperwork, distance of financial institution and/ or religion.

The graph below depicts the self-reported barriers to the usage of an account at any financial insitution according to the Global Findex Database 2014.

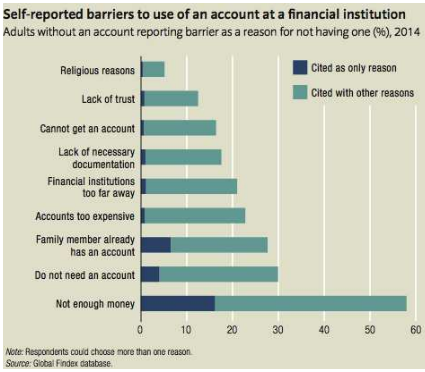

Figure 3

Globally religious reasons were cited by 5 percent of adults. This is evident that with countries having higher percentage of muslim population or muslim majority countries, percentage of adults citing the religion barrier must be higher. Thus to increase financial inclusion, these countries need to develop products that are compatible with the principles of Islamic finance.

FINANCIAL EXCLUSION IN INDIA

As mentioned above, unfortunately India houses the highest number of financially excluded adults in any single country, 21 percent of the world's unbanked population. Since independence, India had adopted a policy of financial inclusion but having 100 percent inclusion is still a distant dream. The policy so far has been on expanding branches, setting up government sponsored institutions and achieving targets of credit disbursement. This having been practiced for over half a century, however, has yielded mixed returns.

As recommended by the Raghuram Rajan committee, a high level Committee on Financial Sector Reforms (CFSR), what is needed is a change in mindset on the part of policymakers, practitioners, and other stakeholders in India to figure out effective ways to provide financial services to the poor. Immediately needed is a set of financial sector reforms that explicitly prioritize inclusion. Financial inclusion should also focus on providing services like savings account, insurance and pensions which would reduce the vulnerability of the poor instead of focussing on only credit which sometime have undesirable results like over-indebtness and inefficient allocation of scarce resources.

So far, government had focussed on the agriculture sector for financial inclusion but this too had been only partly successful. It has been observed that this policy often resulted in benefitting the non-poor people engaged in agriculture as

this was the group that exploited the subsidised agri – credit. The banks preferred to transact with the banakable people within the priority sector and leaving the excluded. The paperwork needed for banking was also found difficult and the poors were left at the mercy of the local money lenders. The government needs to introduce crop-insurance and health insurance to the poor farmers in order to reduce their vulnerability.

It is also high time that India moves on from policy of sector-wise financial inclusion to segments of people who are financially excluded. This is because the Indian economy is diversifying at a fast rate and people are moving from villages to urban areas. Thus, there is a need for coming up with policies that incorporates inclusion of the urban poor, whose numbers are continuously growing.

Another segment that is financially excluded are the muslims. According to Sachar Committee report 80 percent of muslim population is excluded. Muslims, the largest minority group, constitute 14% of the total population of India. This effectively means that more than 50 percent of the financially excluded are muslims. One of the reasons why muslims do not participate in the mainstream-banking is because their faith prohibits them to give and take interest. Thus, it is time to introduce financial products that serve their needs.

Drawbacks of Current Policies of Financial Inclusion:

- Policy focuses on particular sectors of the economy and thus many with the need for inclusion are not even identified.
- The public sector banks are also profit-oriented and consider these rural branches as a burden.
- The government generally has a ceiling for the interest rate for a segment. However, the interest rate charged is market-driven, determination of which is not transparent.
- The banks give loans to those who prove themselves as more ceditworthy and not those who are more needy.
- The exhaustive documentation also acts as a barrier for the excluded to use the credit available.
- Lack of efforts on the part of RBI as well as the government to cater to the financing needs of muslims.

Therefore, there is a need to bring new products, improve the returns on investments and reduce the cost of servicing into the financial mainstream-banking to reach the poorest of the poor.

ISLAMIC ECONOMICS AND FINANCIAL INCLUSION IN ISLAM

Islam is not just a religion but a complete guide to live one's life. It is considered to be a rule-based system which specifies rules for social and economic activities of the society. In this respect, economic principles of Islam deal with rules of resource allocation, production, exchange, distribution and redistribution and thus if these principles are incorporated in true letter and spirit we may get an ideal economic system as envisioned by Islam. It is accepted globally that the central tenet of Islamic economics propagates the equal distribution of resources for the development of the different strata of society and to maximise and utilize the talent of all individuals so that they can contribute towards development of the society as a whole.

The foundation of Islamic economics is based on economic development and growth alongwith social justice. In Islam, it is believed that poverty is not caused by scarcity of resources but is the result of wastage, extravagant behaviour of the rich and exploitation or less payment than the rightfully deserved by the less able segments of the society. Everyone

in the Islamic society must be given the same opportunities to access the natural resources gifted by God. If, unfortunately, someone has no work or is not in a position to work then it is the duty of the society to fulfil his or her minimum requirements for a dignified life.

There is a three dimensional concept of development in Islam: individual or self-development, the physical development of the earth, and the development of the human collectively. The first specifies a dynamic process of the growth of the human being towards perfection. The second dimension of development essentially means the optimum use of available natural resources to fulfil the material needs of the individual and all of humanity. The third dimension of development refers to the progress of the human collectively towards full integration and unity. It is believed that happiness and fulfilment in a person's life is only achieved with a full development of a person along all three dimensions.

In Islam, it is believed that wealth is a blessing by the Creator to be used wisely to support the lives of all of mankind. Extremes of wealth and poverty needs to be avoided so much so that Islam prohibits overspending and waste. It lays stress on the fact that after moderate spending necessary to maintain a modest living standard, surplus must be returned to the members of the society who, for a variety of reasons, are unable to work and hence the resources they could have used to produce income and wealth were utilized by the more able. Islam considers the more able as trustee-agents in using these resources on behalf of the less able. The less able get a share in the income and wealth of the more able through a network of mandatory and voluntary levies.

Financial inclusion is more explicitly emphasized in Islamic finance as compared to conventional finance. The reasons why Islamic finance scores better than the conventional finance to enhance financial inclusion is because it is interest-free and risk-sharing and redistribution of wealth can be called two pillars of Islamic economics.

Inclusion through Instruments of Risk-Sharing

Risk-sharing constitutes the core economic principles of Islam. Islam strictly prohibits all kinds of interest-based contracts. The reason being that a party who wishes to be a beneficiary of profits should also be ready to share the loss if any, and thus profit-sharing and risk sharing is allowed and encouraged together. In the conventional system, risk is borne by only one party (borrower) and the other receives a fixed rate of return (interest) on the investments. Many financial instruments have evolved over time and are practiced in Islamic banking today, namely Mudarabah, Musharakah, Murabaha, Ijarah, Salaam, etc. However, in the context of financial inclusion Islamic Microfinance and Micro-insurance or Micro-Takaful are more significant.

Mudaraba is a profit-sharing contract wherein, supplier of money capital contracts with a working partner on the basis of sharing the resulting profits. Losses, if any, are considered loss of capital and borne by the owner of capital. The working partner, in that case, goes unrewarded for its efforts. This is the 'loss' borne by the working partner, a feature of mudaraba which has made some to characterize it as profit and loss sharing or PLS. The sharing contract when applied to farming is called muzara'ah or share-cropping.

Musharaka is a partnership contract. In partnership two or more parties supply capital as well as work/effort. They share the resulting profits according to agreed proportions, but losses are to be borne in proportion to respective capitals.

Murabaha is a sale agreement under which the seller purchases goods desired by a buyer and sells it to him/her at an agreed marked up price, payment being deferred. The higher price paid would leave a margin for the seller in order to reward him/her for expertise in bargaining, better knowledge of market conditions, etc.

Ijara is a leasing contract that permits one party (the lessee) to use an asset or property owned by another party (the lessor) for an agreed upon price over a fixed period of time.

Salam is a forward financing transaction, where the financial institution pays in advance for buying specified assets, which the seller will supply on a pre-agreed date.

Islamic Microfinance is the investment of capital based on Islamic modes of finance to poor entrepreneurs to help them start up microenterprises or maintain their existing businesses. Islamic microfinance identifies the poorest of the poor as the primary criterion for receiving financial support.

Takaful and Micro-Takaful are basically insurance and Islamic microinsurance (insurance for the poor) contracts respectively. These are considered to be very important social institution in the Islamic community to counter poverty and deprivation. The poor and the weaker section can reduce the risk by means of these instruments.

Inclusion through Instruments of Redistribution in Islam

The Islamic law ensures economic justice alongwith economic growth through rules regarding resource allocation, production, exchange and the distribution of resulting income and wealth. Islam firmly believes that the returns from the use of various resources by the more able must be shared with the less able, who have an equal rights on them. Islam places great emphasis on redistribution of income and wealth and thus legislate institutions for this purpose such as Zakat, Sadaqah, and Qard-al-hasan. These instruments are envisaged to enhance access to financing while addressing equity and contributing to poverty alleviation. The Zakat and the Sadaqah are gifts but Qard-al-hasan is a loan without interest for a needy.

The first redistributive instrument is Zakat, which is also one of the five pillars of Islam. An individual who earns more than what he or she consumes in a year must pay Zakat, which is calculated according to his or her level of net worth (essentially a wealth tax). Its obligations are to the community as a whole: they are to be made specifically and directly to the community’s less fortunate members. The Quran emphasizes the significance of Zakat that it reduces material inequality and enhances brotherhood in the society.

The second instrument of redistribution is Sadaqah which is voluntary social spending. Researchers argue that according to Islam, poverty exists not because economic resources are scarce, but because they are misallocated, inefficiently managed, unproductively hoarded, and unevenly distributed. Thus, independent social spending is the best possible way for members of the Islamic social order to promote a more equitable distribution of wealth and resources. People who can donate more than the obligatory Zakat should share their wealth with the less fortunate.

The third instrument of redistribution is Qard-al-hasan which literally means a ‘beautiful loan’. It is described as beautiful because it is an interest-free loan granted to a needy where the debtor is obligated to return the principal and the creditor does not put any condition regarding the timing of its return; the terms of this loan is decided by the borrower.

CHALLENGES OF INTRODUCTION OF ISLAMIC BANKING

There are number of challenges before we can actually achieve financial inclusion through Islamic banking in India. Foremost among them being devising a regulatory framework satisfying both Islamic and conventional banking systems would be a challenging task for RBI. It may look difficult but many countries in the west and south-east Asia have adopted and successfully doing banking operations in both the platforms and we may look at them and try to incorporate it

into our financial structure. Another challenge would be educating the people about the new banking system that may prove to be tough, given the low awareness levels of conventional banking system. Another thing that needs to be worked on is changing the perception of the majority of the people towards Islamic Banking and making them believe that Islamic banking is not banking only for muslims. Also, there is a serious dearth of Islamic banking experts in India who can manage the banks in the current competitive environment. Nevertheless, the interest-free solutions of Islamic Banking could restore equilibrium in Indian society by providing much needed to debt ridden farmers, labourers and other marginalized groups. Hence, Islamic Banking is a potential tool for financial inclusion.

CONCLUSIONS

Islamic Banking has the potential to create new financial products which can be safer than the existing products. When India is witnessing large number of farmer suicides, interest-free solutions offered by Islamic Banking may bring in hopes to the marginalised groups. Hence, Islamic Banking is seen as a potential tool for financial inclusion.

Surprisingly, the report by Committee on Financial Inclusion did not mention a single word about financial exclusion of Indian Muslims, but the Committee on Financial Sector Reforms brought forth this critical issue of financial exclusion of Indian Muslims. They observed that this exclusion is mostly due to non-availability of interest-free banking and finance. Thus the Committee made following significant recommendations: *"Another area that falls broadly in the ambit of financial infrastructure for inclusion is the provision of interest-free banking. Certain faiths prohibit the use of financial instruments that pay interest. The non-availability of interest-free banking products (where the return to the investor is tied to the bearing of risk, in accordance with the principles of that faith) results in some Indians, including those in the economically disadvantaged strata of society, not being able to access banking products and services due to reasons of faith. This non-availability also denies India access to substantial sources of savings from other countries in the region.*

While interest-free banking is provided in a limited manner through NBFCs and cooperatives, the Committee recommends that measures be taken to permit the delivery of interest-free finance on a larger scale, including through the banking system. This is in consonance with the objectives of inclusion and growth through innovation. The Committee believes that it would be possible, through appropriate measures, to create a framework for such products without any adverse systemic risk impact."

Hence, it becomes increasingly important how RBI recognises the significance of Islamic Banking for inclusive growth in general and financial inclusion of Muslims in particular; and duly recommend the Government of India to amend the Banking Regulation Act. The absence of Islamic Banking in India is resulting in credit loss to Muslims. Economists estimate that interest earned by Muslims worth more than thousands of crores is lying unclaimed in banks across India. It is now time, that the Government alongwith RBI take necessary steps and bring in financial regulation to bring about the much desired socio-economic justice to the Muslims. Financial exclusion of Muslims should no longer be ignored if India wishes to tread the path of economic growth and development.

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